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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9737]

RIN 1545-BK96

Controlled Group Regulation Examples

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final rules with revisions to examples that illustrate the controlled group rules applicable to regulated investment companies (RICs). The revised examples illustrate how the controlled group rules affect the RIC asset diversification tests.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.851-3(b), 1.851-5(b).

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SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR, part 1) relating to the application of the controlled group rules under section 851(c) to RICs.

To qualify as a RIC, a taxpayer must meet asset diversification tests pursuant to which, at the close of each quarter of the RIC's taxable year, not more than 25 percent of the value of the taxpayer's total assets may be invested in (i) the securities (other than Government securities or the securities of other RICs) of any one issuer; (ii) the securities (other than the securities of other RICs) of two or more issuers that the taxpayer controls and that are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses; or (iii) the securities of one or more qualified publicly traded partnerships (as defined in section 851(h)) (the 25 percent tests). See section 851(b)(3)(B).

Section 851(c) provides special rules applicable to the asset diversification requirements of section 851(b)(3), including the 25 percent tests. The controlled group rules in section 851(c)(1) provide that, when ascertaining the value of a taxpayer's investment in the securities of an issuer for purposes of determining whether the 25 percent tests have been met, the taxpayer's proper proportion of any investment in the securities of such issuer that are held by a member of the

taxpayer's "controlled group" must be aggregated with the taxpayer's investment in such issuer, as determined under regulations.

Section 851(c)(3) defines a controlled group as one or more chains of corporations connected through stock ownership with the taxpayer if (i) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and (ii) the taxpayer owns directly at least 20 percent or more of the total combined voting power of all classes of stock entitled to vote of at least one of the other corporations.

On August 2, 2013, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-114122-12 at 78 FR 46851) (NPRM). The proposed regulations would revise certain examples in §1.851-5 to clarify that a RIC and its controlled subsidiary are a controlled group even if the group consists of only that RIC and its subsidiary.

No public hearing was requested or held. Written comments responding to the NPRM were received. The written comments are available for public inspection at <http://www.regulations.gov> or upon request. After consideration of all the comments, these final regulations adopt the provisions of the proposed regulations with certain clarifications. The comments and clarifications are discussed in this preamble.

Summary of Comments and Explanation of Revisions

Comments received in response to the NPRM's request for comments addressed three general categories of issues: (1) application of the proposed

changes to a parent RIC investing in the stock of subsidiary RICs (a Fund of Funds structure); (2) application of the proposed changes to a RIC's indirect investment in qualified publicly traded partnerships, as defined in section 851(h) (QPTPs); and (3) clarification of existing regulatory language implementing the controlled group rules of section 851(c).

1. Fund of Funds

Commenters recognized that the changes to the examples in §1.851-5 apply to structures in which the investments of a RIC (Upper RIC) include stock of one or more subsidiary RICs (Lower RICs). Commenters noted that there may be uncertainty in determining whether an Upper RIC satisfies its 25 percent tests when what might otherwise be a quarter-end violation by the Lower RIC is saved from being a violation by one or both of the relief provisions in section 851(d)(1) (sometimes called the "market value exception" and the "30-day cure provision") or when the Upper RIC and a Lower RIC have different quarter end testing dates.

To resolve this uncertainty, commenters urged the Treasury Department and the IRS either to provide a safe harbor for Fund of Funds structures or to exempt these structures from the controlled group rules. Commenters noted that securities of RICs are listed as qualifying assets for purposes of the "good asset" 50 percent test of section 851(b)(3)(A) and are correspondingly excluded from the categories of assets listed in the 25 percent tests set forth in sections 851(b)(3)(B)(i) and (ii). In response to these requests, the Treasury Department and the IRS are issuing Revenue Procedure 2015-45 (2015-39 IRB dated September 28, 2015), which describes conditions under which the IRS will treat

an Upper RIC that invests in one or more Lower RICs as satisfying the 25 percent tests and provides procedures to lessen the burden of demonstrating compliance with the 25 percent tests, applying the market value exception and the 30-day cure provision, and dealing with different quarter-end testing dates.

2. QPTPs

Comments were received both on the revised language in Example 1 and on proposed Example 7. Example 7 illustrates the application of the controlled group rules to a RIC's indirect investment in securities of QPTPs.

In 2004, Congress enacted section 851(b)(2)(B), which facilitated investment by RICs in equity interests of QPTPs by providing that net income from an interest in a QPTP would be treated as qualifying income under the RIC income test set forth in section 851(b)(2) without regard to the character of the income earned by the QPTP. Congress provided for this new ability of RICs to invest in QPTPs to improve QPTP access to U.S. capital markets.¹

At the same time, however, Congress enacted section 851(b)(3)(B)(iii), which limits a RIC's investment in securities of one or more QPTPs to not more than 25 percent of the value of the RIC's assets. The Ways and Means Committee report explained the rationale for this limitation by stating:

¹ "The Congress understood that ...[p]ublicly traded partnerships with specified types of income are not treated as corporations, however, for the reason that if the income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation. The Congress understood that these types of publicly traded partnerships may have improved access to capital markets if their interests were permitted investments of mutual funds. Therefore, the Act treats publicly traded partnership interests as permitted investments for mutual funds ('RICs')." Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress at 249 (JCS-5-05), May 2005 (footnote omitted).

[T]he Committee bill requires that present-law limitations on ownership and composition of assets of mutual funds apply to any investment in a publicly traded partnership by a mutual fund. The Committee believes that these limitations will serve to limit the use of mutual funds as conduits for avoidance of unrelated business income tax or withholding rules [for effectively connected income] that would otherwise apply with respect to publicly traded partnership income.

H.R. Rep. No. 108-548, pt. 1 at 152 (2004). Commenters relied on this legislative history in support of their position that the section 851(b)(3)(B)(iii) QPTP test (which focuses on a RIC's holdings of securities of a category of issuers) is fundamentally different from the section 851(b)(3)(B)(i) and (ii) tests (which focus on a RIC's holdings of securities of particular issuers). These commenters contended that an interest in a QPTP should not be subject to the clarified controlled group rules in the NPRM when the interest in the QPTP is held by a corporation that is not a RIC.

The Treasury Department and the IRS do not find this argument sufficiently persuasive to overcome the plain language of section 851(c) regarding the application of the controlled group rules. Pursuant to its introductory language, section 851(c) applies generally “[f]or purposes of subsection 851(b)(3),” and pursuant to section 851(c)(1), the look-through rule for controlled group members applies specifically “for purposes of subparagraph (B)” of section 851(b)(3), in each case without distinguishing between the various 25 percent tests. Moreover, the Treasury Department and the IRS note that Congress, in the same legislation in which it enacted section 851(b)(3)(B)(iii), had the opportunity to amend these rules in the manner urged by the commenters. In that legislation, Congress made other changes to conform section 851(c) to the

changes relating to QPTPs by redesignating former section 851(c)(5) as section 851(c)(6) and adding a new section 851(c)(5), which defines the term “outstanding voting securities of such issuer” to include equity securities of QPTPs. Congress made no changes, however, to limit the application of the section 851(c) controlled group rules to solely the 25 percent tests under section 851(b)(3)(i) and (ii).

Thus, the Treasury Department and the IRS believe, consistent with the statutory language, that the controlled group rules should apply to section 851(b)(3)(B)(iii) because (1) Congress specifically provided that a RIC’s investment in QPTP securities should be limited to 25 percent of the RIC’s total asset value; (2) the controlled group rules of section 851(c) by their terms apply to all of section 851(b)(3), including section 851(b)(3)(B)(iii); and (3) Congress did not carve out section 851(b)(3)(B)(iii) when it updated section 851(c).

3. Clarifying regulatory language

Some practitioners have interpreted section 851(c)(3) to require the presence of at least two levels of controlled entities for a controlled group to exist and have relied on certain of the examples in the existing regulations to support this interpretation. These final regulations clarify, through revisions to the existing examples, that as few as two corporations are enough to constitute a controlled group if the ownership requirements of section 851(c)(3) are met.

The Treasury Department and the IRS believe that the interpretation of the controlled group rules reflected in these final regulations is consistent with both the statutory language of section 851(c)(3) and the well-established interpretation

of analogous Code provisions. For example, for purposes of the consolidated return rules, the IRS has consistently treated a parent and its directly owned subsidiary as “affiliated” within the meaning of section 1504(a)(1). Similarly, in limiting certain tax benefits for affiliated corporations, the IRS treats a parent and its subsidiary as a “controlled group” under section 1563, which uses language similar to section 1504(a). See section 1563(a)(1) and §1.1563-1(a)(2)(ii), Example 1. The interpretation reflected in these final regulations is also consistent with the purpose of section 851(c)(3), which is to aggregate the investments of a RIC’s related corporations for purposes of determining whether the RIC satisfies its 25 percent tests.

As stated in the preamble to the NPRM, the Treasury Department and the IRS believe that the language in the examples in the existing regulations was intended merely to simplify the description of certain fact patterns and not to articulate a legal interpretation that is inconsistent with the statutory language of section 851(c) and the construction of substantially similar language elsewhere in the Code.

Commenters noted that §1.851-3 states that “[i]n determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(3), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer” (emphasis added). Commenters cited the phrase “any one issuer” in support of the proposition that the controlled group rules should not be applied for purposes of section 851(b)(3)(B)(iii), which

addresses not the value of a RIC's direct and indirect holdings of securities of any single issuer but rather a RIC's aggregate direct and indirect holdings of securities of a category of issuers (that is, QPTPs). While the Treasury Department and the IRS do not believe that the use of "any one issuer" in §1.851-3 bears the weight these commenters attribute to it, in order to respond to the comment and more closely align §1.851-3 with the statutory language of section 851(c)(1), these final regulations update the language of §1.851-3 by changing "any one issuer" to "an issuer."

Commenters similarly maintained that because section 851(c)(1) refers to use of the controlled group rules "in ascertaining the value of the taxpayer's investment in the securities of an issuer" (emphasis added), the rules should not apply for purposes of a limitation that applies to holdings of securities in a category of issuers, such as the section 851(b)(3)(B)(iii) limitation on investment in QPTPs. The Treasury Department and the IRS do not agree with this reading of the statute. As noted above, the controlled group rules expressly apply for purposes of section 851(b)(3)(B) without qualification. The Treasury Department and the IRS believe that the more natural reading of the statutory language is that, in assessing compliance with section 851(b)(3), a RIC applies the controlled group rules to determine its indirect holdings in each individual issuer (including each QPTP), and the RIC then aggregates its direct and indirect holdings in each individual issuer for purposes of applying the test in section 851(b)(3)(B)(i); aggregates its direct and indirect holdings of securities of issuers engaged in the same or similar trades or businesses or related trades or businesses for

purposes of applying the test in section 851(b)(3)(ii); and aggregates its direct and indirect holdings of securities of issuers that are QPTPs for purposes of applying the test in section 851(b)(3)(iii).

Finally, commenters suggested that operative rules should be set forth in substantive rules in addition to being demonstrated in the examples. They urged the Treasury Department and the IRS to provide regulatory text setting forth general rules, with the examples in §1.851-5 demonstrating the application of those rules. The Treasury Department and the IRS believe that the revised examples are intended to, and do, make sufficiently clear how the statutory rules are to be interpreted and applied, and accordingly no changes are being made in response to this comment.

Applicability Date

The final regulations apply to quarters that begin on or after **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**. Under section 851(d)(1), whether a taxpayer loses status as a RIC in one quarter may depend on whether the taxpayer satisfied section 851(b)(3) and (c) at the close of one or more prior quarters. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after **[INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, these final regulations apply in determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses. No comments were received.

Drafting Information

The principal author of these regulations is Julianne Allen, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Sections 1.851-3 and 1.851-5 are also issued under 26 U.S.C. 851(c).

* * * * *

Par. 2. Section 1.851-3 is revised to read as follows:

§ 1.851-3 Rules applicable to section 851(b)(3).

(a) In general. In determining the value of the taxpayer's investment in the securities of an issuer, for purposes of subparagraph (B) of section 851(b)(3), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See Example 4 in §1.851-5. For purposes of §§1.851-2, 1.851-4, 1.851-5, and 1.851-6, the terms “controls,” “controlled group,” and “value” have the meaning assigned to them by section 851(c). All other terms used in these sections have the same meaning as when used in the Investment Company Act of 1940 (15 U.S.C., chapter 2D), as amended.

(b) Effective/applicability dates. The rules of this section apply to quarters that begin on or after **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after **[INSERT DATE 180 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**, the rules of this section apply in

determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

Par. 3. Section 1.851-5 is revised to read as follows:

§1.851-5 Examples.

(a) Examples. The provisions of section 851 may be illustrated by the following examples:

Example 1. (i) Investment Company W at the close of its first quarter of its taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	<u>20</u>
Total	100

(ii) Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of regulated investment companies and various other corporations. Neither Corporation A nor Corporation B owns:

(A) 20 percent or more of the voting stock of any other corporation;

(B) Securities issued by Corporation C; or

(C) Securities issued by any of the regulated investment companies or various corporations whose securities are owned by Investment Company W. Except for Corporation A and Corporation B, none of the corporations (including the regulated investment companies) is a member of a controlled group with Investment Company W.

(iii) Investment Company W meets the requirements under section 851(b)(3) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(3) because it has 55 percent of its assets invested as provided in that subparagraph. It complies with subparagraph (B) of section 851(b)(3) because it does not have more than 25 percent of its assets invested in the

securities of any one issuer, of two or more issuers that it controls, or of one or more qualified publicly traded partnerships (as defined in section 851(h)).

Example 2. (i) Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	<u>21</u>
Total	100

(ii) Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(3) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example 3. (i) Investment Company X at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	<u>40</u>
Total	100

(ii) Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b)(3) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example 4. (i) Investment Company Y at the close of a particular quarter of its taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	<u>25</u>
Total	100

(ii) Corporation K has 20 percent of its assets invested in Corporation L, and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L.

(iii) At the end of that quarter, Investment Company Y is disqualified under subparagraph (B)(i) of section 851(b)(3) because, after applying section 851(c)(1), more than 25 percent of the value of Investment Company Y's total assets is invested in the securities of Corporation B. This result is shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested indirectly through K and L (30% x 20% x 40%)	2.4
Percentage invested indirectly through A (10% x 30%)	<u>3.0</u>
Total percentage of assets of Investment Company Y invested in Corporation B	25.4

Example 5. Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 2016 meets the requirements of section 851(b)(3) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions, it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in

Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 2016 because of such distributions, nor will it lose its status as a regulated investment company for any subsequent year solely as a result of such distributions. See section 851(d)(1).

Example 6. Investment Company Q, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 2016 meets the requirements of section 851(b)(3) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 2016, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Investment Company Q does not lose its status as a regulated investment company for the taxable year 2016 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for any subsequent year solely as a result of such market value fluctuations. See section 851(d)(1).

Example 7. (i) Investment Company T at the close of a particular quarter of its taxable year has its assets invested as follows:

	Percent
Cash and Government securities	40
Securities of Corporation A	20
Securities of various qualified publicly traded partnerships (within the meaning of sections 851(b)(3) and 851(h))	15
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	<u>25</u>
Total	100

(ii) Investment Company T owns more than 20 percent of the voting power of Corporation A and less than 10 percent of the voting power of all of the other corporations. Corporation A has 80 percent of its assets invested in qualified publicly traded partnerships.

(iii) Investment Company T is disqualified under subparagraph (B)(iii) of section 851(b)(3), because, after applying section 851(c)(1), more than 25 percent of the value of Investment Company T's total assets is invested in the securities of one or more qualified publicly traded partnerships. This result is shown by the following calculation:

	Percent
Percentage of assets invested directly in qualified publicly traded partnerships	15.0
Percentage invested in qualified publicly traded partnerships indirectly through A (20% x 80%)	<u>16.0</u>
Total percentage of assets of Investment Company T invested in qualified publicly traded partnerships	31.0

(b) Effective/applicability dates. The rules of this section apply to quarters that begin on or after **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after **[INSERT DATE 180 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**, the rules of this section apply in determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: September 2, 2015.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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